CRUDE OIL PRICES – RIGHT TIME FOR ANOTHER JEDDAH SUMMIT?

Crude Oil as a commodity fuels the everyday life of individuals on this planet. From the motor transportation fuels, to the heating and cooking fuels as well as petrochemicals, all are coming from this commodity and have been the continual source of energy for the planet for over a century.

The global demand for crude oil has hovered in the range of 94 to 96 million barrels per day and the supply has also been in the similar range. While there has been fluctuation in the supply and demand matrix, this has been fractional when considered as a percentage of the overall demand and supply.

We have nevertheless witnessed the price of crude oil fall sharply from USD 118 per barrel in June 2014 to below USD 30 per barrel . It is mind boggling that the commodity which was just two years ago being predicted to be headed to USD 150 per barrel levels, has now tanked to below USD 30 per barrel without anyone cocking an eyebrow and that too without any structural demand or supply shift.

While it is a good thing to happen for net oil importer countries such as India, yet it needs to be acknowledged that the price of the commodity falling drastically without a change in the underlying economics, will have more negative than positive effects for all the stake holders in the medium to long term affecting the oil investments .

For the oil producers the fall in crude oil price spells a massive reduction in the revenue generation thereby unsettling the national budgets and economies. Oil producing countries where oil is the main source of revenue , peg their budget break even at crude oil prices which are much higher than the prevailing oil price levels. The spending by such countries on domestic infrastructure as well as further oil exploration and development has been factored into the national budgets at much higher crude oil prices than they are seeing at this point of time. Nevertheless major oil producer of the OPEC desisted from supply cuts apprehending loss of market share.. Subsequently the crude oil prices have fallen from USD 70 per barrel to below USD 30 per barrel in the last 12 months itself.

For the oil importing countries such as India with increasing oil consumption, such situation reduces the import bill. However, continuous fall of crude oil price to very low level could hurt the investment capital available from foreign investors on the one hand, as well as deplete the spending power of oil rich countries thereby hurting exports. More so the reduction of the foreign funds inflow into the country and the flight of capital at the back of redemptions by the oil rich investors, in turn hurts the currency and negates the effect of the crude oil price fall. Thus beyond a level the fall in crude oil price does not benefit oil importers either.

While there has been a school of thought that the lower crude oil prices may push out the new exploration and development activities in deep sea exploration acreages owing to non-viability, and the fact that frontier resources such as shale oil & gas production could be marginalized with crude oil prices falling below their break-even production costs and thereby the supply side would check itself and gradually the prices would stabilize and head north. This theory does not seem to be playing out soon enough for the oil producers as crude continues to slide month after month.

To add to the concerns of the oil producers about continued oversupply of oil in the market, the imminent possibility of Iran returning to the market with easing of sanctions, the prospects of oil prices stabilising soon appears less probable. Further, US dismantling the decades old ban on oil exports, thereby becoming a contributor to the global oil and gas supply pool, adds to the woes.

In the face of such complex dynamics of the international oil scenario, a question arises about what should oil producers do ?. Should they sit idly and watch the capitulation of the market which affects their future? Or should they begin to look at other than crude oil for source of national income?

The answer may be a simplistic one which may have gotten obfuscated in the complexity of market movements.

To address the issue one may need to go back to the basics.

The primary determinant of oil prices is demand and supply or fundamentals. While there has been some fluctuation in demand with possible over supply, this has been marginal and definitely not significant enough to merit such a major continuous downfall of crude oil prices as experienced in the recent months. There certainly hasn't been a major correction in demand figures by 10-20% or oversupply by 10-20%. On the contrary organizations such as IEA forecast the global energy demand rising by almost $1/3^{rd}$ by 2040. Without timely investments for enhancing production capability by oil producers, how will the increased global crude oil demand be met ?

Yet the crude oil prices continue to fall.

What's amiss?

What is amiss is the very reference point of the oil price and its determination by non-oil players. The crude oil price we talk about is referred in terms of the price of benchmark crude oils Brent, WTI, Dubai and Oman.

Benchmark crude oil prices are not directly determined by the demand supply levels of physical crude oil traded but by the quotes of paper/future trades in exchanges/publications on a daily basis. Volume of paper trade is many times the physical oil production. It is a well-known fact that most of such trades are settled on paper without physical delivery of crude. Apparently such transactions seem to be speculative in nature. Thus in theory entities with deep financial pockets, participating in paper markets could lead to net short non-commercial positions and bring down the oil prices substantially without their being any real change in the demand supply realities of crude oil in the physical market.

This is where the main problem lies and is possibly being overlooked by the oil producers. Set in their own ways of routine working they continue to peg their national resource production to prices determined by these 'paper markets' which are neither in their control nor of their making. Whose interests are served by such markets ?

<u>The producers of crude oil need to move away from paper market quotes of benchmark crudes as pricing basis!!!! They need to de-link their physical oil prices from these artificial and manipulative paper market price levels. Financialisation of oil markets has to end and give way to fundamentals.</u>

Rather than pricing crude oil based on paper quotes and only determining for themselves the premium or discount, they need to determine and announce the per barrel total price of their crude oil grades. This would need to be worked out objectively and responsibly.

The OPEC thus needs to change its role from determining the quantity of crude oil to be produced, to determining the fair price to be charged by its members . Other non-Opec crude oil producers could individually do the same.

Considering the fact that the OPEC nations control around one-third of the global oil production, they have the pricing power and basis to determine what levels the commodity being produced by them ought to be sold at. As per basic trading economics it is for the producers and the consumers to negotiate and agree on the prices based on supply demand fundamentals . It is not for non-commercial third parties to determine the oil price on an exchange based on pure paper/speculative transactions.

In this manner the pricing of a commodity as important and strategic as crude oil would be free from price movements arising out of financial speculators actions and in the medium to long term the prices would stabilize as per the real physical demand supply scenario. It would eliminate speculative volatility in crude oil prices and bring stability to the macro economic scenario.

The above practice would thus be in the long term interest of not only the crude oil producers but also all consuming countries as well. It is time to unshackle real economies and business from the speculative paper markets which have in the past wrecked many sectors such as housing and brought economies to knees.

There are no overnight solutions to such problems of oil industry. There are hurdles and need for arriving at solutions through united, focused, consultative joint approach .

In June 2008 King Abdullah of Saudi Arabia had called for Jeddah summit of producers and consumers when oil price had reached the $130- 140 per barrel range to address the growing anger and frustration caused by surging prices in oil importing countries. Divergent views emerged for the cause of oil price rise – selfish interests of speculators to oil demand rising faster than supply. However it should be remembered that rising to $147 per barrel in July 2008 the crude oil prices crashed to below $ 40 per barrel in December 2008.

Today there is growing anger and frustration in oil exporting countries due to falling crude prices severely affecting economies . Differing views prevail for the causes – oil supply rising faster than demand, record inventories, global recession, shale oil & gas availability and others. Can the prices climb from 20s to $ 130 per barrel by end 2016 ?

Is 2016 the right time for another Jeddah Summit ?

Written by :
A.S. Ujwal
Anshuman Khanna
Value Prolific Consulting Services, India

22nd January 2016